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UNCLAS SECTION 01 OF 04 FRANKFURT 007207

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SUBJECT: Drama in EU Clearing and Settlement Heightens: US  
Threat Catalyst for Unification?

T-IA-F-05-033

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11. (SBU) Summary: European securities infrastructure industry of stock exchanges, clearing and settlement activities is among the most dynamic in the financial industry, undergoing substantial change in the last decade. As the European Commission (EC) prepares to decide whether to propose EU legislation for clearing and settlement systems, drama over the future shape of the industry is heightening. Taking a cue from the City of London, EC Commissioner McCreevy suggested that a pan-European clearinghouse would be an "interesting prospect." Indeed, it could cut costs of cross border transactions and satisfy supervisory, competition policy and users' interests.

12. (SBU) Shareholders in privately owned LCH.Clearnet and Eurex might not have been expected to be enthused. As if on cue, a week after the McCreevy statement shareholders of Euronext suggested that Euronext merge with Deutsche Borse for exchange trading, possibly spinning off the clearing operations of both. Filling the stage, the Italian competition authorities have opened their own inquiry regarding Borsa Italiana's operation of a clearing system. Maybe the creation of a pan-EU clearinghouse would produce a happy ending, but it would still leave nettlesome tax and legal obstacles to integration. Maneuverings in Europe need to be appreciated with one eye on the US. Failure to consolidate more quickly in Europe could leave European exchanges vulnerable to a takeover from the US - an issue that gets the continental blood pumping. The drama may be notching up. End Summary

To Legislate nor Not Legislate, that is the Question  
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13. (SBU) A major obstacle to a more integrated, efficient EU securities market is separate national clearing and settlement systems. Clearing means validation of trades and preparation for settlement (e.g. information on securities transaction codes, settlement date, settlement venue, etc.). Settlement is the transfer of the ownership of the securities and corresponding transfer of cash. A group of private experts led by Mr. Alberto Giovannini, Chairman of Unifortune Asset Management, has produced two reports detailing the obstacles to a more efficient European cross-border clearing and settlement.

14. (SBU) Over a year ago the EC floated the notion of a EU directive to create uniform regulatory and governance rules, including requirement for trades on any exchange to have access to the clearing system of their choice. The idea is that common rules would facilitate cross-border consolidation, helping to drive down cross-border processing costs that run six times that of domestic transactions. The EC is preparing an economic impact study that will show that a fully integrated EU clearing and settlement operation would, in fact, reduce costs. The question they have not yet answered is whether legislation is necessary and capable of achieving that objective. EC officials intend to take a decision on whether to proceed with legislation will be made around the end of the first quarter of 2006.

15. (SBU) The ECB has been outspoken in favor of a framework directive to enhance stability of EU payments systems. The ECB and the Committee of European Securities Regulators (CESR) were so keen on rules that they drafted clearing and settlement "standards" without waiting for legislation or, in the case of CESR, a mandate from the EC. This procedural end run has been sharply criticized, most recently at the September 13 hearing of the Economic and Monetary Affairs Committee that put CESR's Chairman in the

dock. The draft standards have attracted considerable criticism for both the process by which they have been drawn up and their content. Rather than finalizing them a year ago, ECB and CESR have been refining the text and will release a new discussion draft in October, with a view to completing it by the spring. Some observers speculate that the timing aims to coincide with the EC's possible proposal for a directive, allowing the EC to regain its rightful lead in drafting EU legislation.

#### City of London Goes Continental: A Case of Role Reversal

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16. (SBU) Regulation is favored in another quarter, namely by the Chairman of the London Stock Exchange (LSE). In July he called on the EC to lead a rigorous debate about the "structure of post-trading services," as well as their "ownership." The LSE has favored clearing operations to be regulated as a public utility. The logic is that since all trades have to be "cleared," and that only one clearing system can efficiently exist for a specific financial instrument in a domestic market, it should be regulated as a public utility, like a telecom network, since all traders have to use it.

17. (SBU) A curiosity is that the traditionally market-oriented City of London is championing a government-directed approach. In this case it is understandable. The LSE is the only major European exchange that does not own or have financial interest in post-trading operations. Thus, it is easy for them to propose measures that affect only their competitors.

18. (SBU) In a bit of role reversal, the continental exchanges and clearing and settlement operators have favored a market-oriented solution, not government intervention. No surprise again. Deutsche Borse's Eurex and LCH.Clearnet, in which Euronext, the conglomeration of four of Europe's stock exchanges, has a major stake, are privately owned, publicly traded institutions.

#### Commission: Market Solution or Government Lead Market Solution?

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19. (SBU) EC Commissioner McCreevy has sought to stir the pot with a September 13 speech in which he mused that the creation of a pan-EU clearinghouse is an "interesting prospect." One EC official reported that McCreevy wanted to provoke a reaction from industry. Another said that industry talks and talks, but has not developed a clear approach for the EU clearing industry. The speech was a "wake up call" to get their act together in the next six months and develop concrete ideas.

110. (SBU) The EC has been sympathetic to market-lead consolidation. Indeed, consolidation in trading, clearing and settlement has "proceeded at an unprecedented pace in the last few years," according to a study prepared for DG Competition finalized in July. Eurex clearing is the product of the merger of seven regional central securities depositories in Germany. Clearnet provides clearing services for Euronext changes, i.e. Paris, Brussels, Amsterdam and Portugal. The most significant consolidation was the 2003 merger between Clearnet, which was 80% owned by Euronext, with the London Clearing House, which provided clearing services for the LSE, into a new entity, LCH.Clearnet.

#### Consolidation: Vertical In Practice, But Not Ownership

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111. (SBU) Market-driven consolidation sounds good in principle, but UK regulatory authorities and investment bankers take a different view when it comes to trading linked to clearing operations. In July the UK Competition Commission's provisional findings in its inquiry regarding the possible acquisition of the LSE, states that both suitors of the LSE - Deutsche Borse and Euronext -- would either have to divest themselves of their clearing operations or follow strict governance rules to ensure clearing operations would not be influenced by the trading interests of the exchange. The logic of the Competition Commission was that "vertical integration" in which an exchange also owns a clearing operation, could result in the clearing operation rising fees or even denying access to "captive traders" on the exchange, increasing costs or barriers to entry. This, in the Competition Commission's view, may give rise to a "substantial lessening of competition" for the provision of exchange trading.

112. (SBU) The London Investment Banking Association (LIBA) wholeheartedly endorsed this logic. In an extraordinary presentation last February, LIBA asserted that vertically integrated structures present "risks of price discrimination and unfair access terms." Clearing and settlement

operations should have "hard wire" governance rules that give users' interest "top priority" and ensure effective separation from the operation of the exchange. Better yet, in LIBA's view, the clearing operations should be separate entities owned by users.

¶13. (SBU) Here is another curiosity. LIBA's members tout the attributes of shareholder value for their clients, but, in this case, don't seem to care about the shareholders of Deutsche Borse and Euronext. Not so long ago, investment banks owned one of the major cross-border central securities depositories, CEDEL, but sold it to Deutsche Borse. London City financial experts dismiss these points as irrelevant to today's market. The market provides its share of irony.

¶14. (SBU) The report on European clearing and settlement systems prepared for DG Competition took a more detached view on "vertical integration." It pointed out that all countries have vertical systems either through ownership (like Germany, Italy and Spain) or through exchange laws or membership rules (even on the LSE) that require trades on the exchange be cleared and settled through a designated entity. One exchange expert points out the obvious fact that have one clearing entity for an exchange is efficient for all concerned. Thus, the issue is not the link between an exchange and clearing operation in practice, but rather the ownership of both that could lead to abusive behavior.

#### Shaping of the Market to Come

¶15. (SBU) There is little doubt that unification of EU post-services operations would help integrate EU securities markets and reduce transaction costs. A July 2005 study by the ECB staff has suggested that most research supports the notion that EU costs in cross-border clearing and settlement are significantly higher than those in the US. The study also notes that vertical integration has positive features and that market-driven solutions are generally the best at allocating resources to create an efficient securities infrastructure.

¶16. (SBU) ECB experts' outlook was cautious, declaring that it would appear premature to "draw up any final conclusions regarding policy and optimal form of consolidation." Important elements to any solution would be proper governance to protect from conflicts of interest and to ensure rigorous competition.

¶17. (SBU) Based on these conclusions, one clearing entity at the EU level could make sense, provided it was fashioned by the market, not imposed from above. Again, on what appears to me another cue in the drama, a week after the McCreevy speech, shareholders of Euronext reportedly suggested that the firm target a merger with Deutsche Borse rather than LSE. The clearing operations of both - Eurex clearing and LCH.Clearnet would be spun off and sold to users, a prospect that LCH.Clearnet has raised, but one that Deutsche Borse officials reject. Filling the stage, on September 20 Italian competition authorities announced an inquiry into Borsa Italiana's ownership of clearing operations for the exchange it operates in Milan. This is getting to be like a chorus in a Greek drama.

¶18. (SBU) The market solution of major EU clearing operations merging would appear to give competition authorities and users what they want: a clearing institution independent of exchanges and responsive to users' needs. EC officials confess to being intrigued with the US DTCC that is such the single clearing entity in the US for equity securities.

¶19. (SBU) A pan-EU clearinghouse would not mean full integration of the EU market. The Giovannini expert group identified technical, tax and legal obstacles to EU integration in clearing and settlement. The above merger would address technical aspects, but not the more difficult legal and tax issues. Indeed, the Giovannini group warned that if only technical issues were solved, e.g. interoperability of systems, risks would actually increase with trading volume as the legal and tax problems would grow commensurately. The EC has established working groups to tackle all three obstacles, but the ones on legal and fiscal cannot produce quick fixes, as they would require changes in national legislation.

#### Defi American, Encore: Unifying Force and a Plus for the EC?

¶20. (SBU) A subplot in the European drama on the consolidation of the securities infrastructure industry is the role of US industry. There is a concern that the New York Stock Exchange might be interested in taking over the LSE. The US DTCC has expressed its interest in opening clearing operations in London. This specter adds some

urgency to Euronext and Deutsche Borse's strategies - possibly joining them in common cause.

121. (SBU) Well before the recent suggestion of Euronext shareholders, German market observers suggested a merger between Deutsche Borse and Euronext if both failed to takeover the LSE, in light of UK market and official resistance (recall the UK Financial Service Authority's open letter to the press clarifying that whoever owned the LSE, the LSE would be supervised by the FSA - a point underscored in the UK Competition Commission's provisional findings). A former Deutsche Borse official recalls they were close to such a merger three years ago. While competition issues might have to be considered, they may not be as onerous as some expect. The UK Competition Commission's provisional findings indicate that the "relevant market" to gauge competition in securities trading is not the UK or even Europe, but Europe and the US.

122. (SBU) A unified continental exchange would appear not to be a threat to competition and could provide the EC a policy bonus. It would allow the EC to recapture the policy debate now being driven by UK supervisory and competition authorities and mark a major step toward integrating EU securities markets. A bold initiative on clearing and settlement could be a centerpiece for the EC's economic agenda that, one can kindly say, has lacked pep. Nothing like a rival from the other side of the Atlantic to get the continental blood boiling.

123. (U) This report coordinated with Embassies Berlin, London and Rome and USEU

124. (U) POC: James Wallar, Treasury Representative, e-mail wallarjg2@state.gov; tel. 49-(69)-7535-2431, fax 49-(69)-7535-2238

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